India's Investment Environment – March 2009

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I. Introduction

India is growing faster than the more mature economies of the world – a phenomenon which is luring investors into India. The January 2009 figures of FDI inflows into India are clear indicative of this. At a time when the world is facing the worst credit freeze, India attracted $2.7 billion FDI in January 2009, which exceeds last year's figures for the same month by 58.8 percent. In the last eight months of the current fiscal, foreign investment inflows also grew by 90 percent. In this period the investment from three Asian countries – Mauritius, Singapore and Japan – contributed more than 55 percent of the total inflows. While Mauritius remains the largest source of foreign investment in India, other tax havens such as Cyprus are gaining ground as favourite routes for channelling FDI. Meanwhile, Singapore has replaced the US as the second largest source of long term investments into India.

II. Expected changes in FDI rules

The following changes in FDI rules are expected in the near future:

(i) Indian –owned and controlled companies must have resident Indians at helm
The government is slated to issue a stipulation that for a company to be classified as Indian owned and controlled, positions of chairman, managing director, CEO and CFO should be filled by resident Indians. The appointment of these positions from among resident Indians will have to be made in consultations with serious Indian investors i.e., meaning those who hold at least 10 percent equity in the company. These conditions are being issued as a clarification to DIPP Press Notes 2 and 3 of 2009, which formulated notions of Indian and foreign ownership of companies incorporated in India.
The new conditions are meant to check attempts by foreign companies for gaining entry into sectors where foreign investment is prohibited through bogus partnerships and proxy Indian companies and partners. The issue at stake is the national identity of investment in a sensitive sector.

(ii) Three year lock-in period for foreign companies manufacturing power equipments
To discourage non-serious players the government is expected to stipulate a three year lock-in period for MNCs setting up facilities for manufacturing new generation power equipments. The Government is planning to use large and fuel efficient super critical equipments in all new power projects. At present these equipments are not manufactured

in India. Current FDI guidelines governing power equipment manufacturing do not have any provision to stop fly-by-night operators. However, the sector is open to 100 percent FDI under the automatic route.

The equity lock-in clause would ensure that there would be no bids from foreign companies whose track record is not satisfactory. The tenders would also make it mandatory for all interested companies to get technology transfer agreements in place before bidding begins. Moreover, the companies winning in the bulk tendering will have to adhere to a phased manufacturing programme with monitoring of milestones and levels of indigenisation achieved.

(iii) M&A with foreign companies may be allowed via share swap

The government is considering allowing the acquisition of stakes by foreign and Indian companies in each other's operations through share-swap deals that do not involve any cash exchange. Importantly, the shares offered could be that of another company within the group that is not the party to the deal.

As per the current FDI policy, issue of shares for consideration other than cash, such as warrants, requires an approval from FIPB but the policy does not explicitly stipulate that foreign firms need an approval from the FIPB in the case of a share swap. Now with the revised policy the government is considering allowing share swaps between Indian and foreign companies with prior permission of the FIPB.

(iv) RBI relaxed norms allowing NBFCs to avail of ECB

With the continuing liquidity crunch in the debt market for infrastructure projects, RBI has relaxed the norms pertaining to use of ECB from multilateral/regional financial institutions and government owned development financial institutions by Non-Banking Financial Companies (NBFCs) for on-lending to borrowers in the infrastructure sector via FIPB route. While considering applications, RBI will take into account the direct aggregate commitment of these lenders to the infrastructure sector in India. The direct lending portfolio of these lenders vis-à-vis their total ECB lending to NBFCs should not be less than 3:1 at any point of time.

The purpose of this relaxation is to inject more debt funds into the resource starved infrastructure sector, including PPP projects.

(v) Government set to clear confusion about Press Note 1 of 2005

The government is expected to come out with a clarification stating that Press note 1 of 2005 would not be applicable in cases where joint ventures involving foreign companies do not exist anymore. Press Note 1 makes it mandatory for a foreign company to get a no objection certificate (NOC) from its Indian partner before setting up a new business in the country in the same field.

The government had earlier planned to scrap Press Note 1, but it was resisted by domestic players. At present exemptions are being granted by FIPB on a case-to-case basis as FIPB clearance is mandatory in such cases.

Press Note 1 was formulated to dilute an earlier government provision through Press Note 18, which stipulated that the foreign company had to furnish a NOC from an Indian partner if it planned to set up a wholly-owned subsidiary even in an allied field. Press Note 1 has restricted the need for an NOC to the same activity only.

III News & Views

(i) Press Note 4 of 2009 is appreciated for abolishing Press Note 9 of 1999

Press Note 4 of 2009 is being appreciated for having done away with Press Note 9 of 1999, which had posed, perhaps unintentionally, a roadblock to FDI. Press Note 9 of 1999 was supposed to simplify down stream investment procedures and introduce the concept of holding cum operating companies. But the FIPB took a stand that all investments, notwithstanding the availability of the automatic route and regardless of the percentage of FDI in the operating company or that of the down stream investment, had to seek FIPB approval.

However, it is being debated whether the recent FDI policy changes through Press Note1, 2 and 3 of 2009 will achieve the prime concern of encouraging FDI, while effectively protecting the security sensitive sectors in the national interest. It is being argued that the scope for net economic ownership through indirect holding has been enhanced in the hope of incentivising volume of investments. However, foreign investors having diverse entry strategies, on balance, will not cede on control and veto rights that easily.

(ii) Allow ECBs by NBFCs under automatic route

The permission to NBFCs to avail of ECB for on-lending to borrowers in the infrastructure sector is based on the assumption that the available funds of the multilateral/regional financial institutions exceed the amounts they are lending directly to projects which can be tapped by NBFCs. It has been pointed out that this very assumption might be a mistake.

Whether allowing NBFC borrowing under approval route requires a re-look, is another topic of debate. As infrastructure companies have been allowed to raise ECBs to the extent of $500 million through the automatic route, it may be worthwhile to give similar dispensation to NBFCs. It is being argued that as the global financial markets are volatile, the speed with which an opportunity can be tied up is critical to the success of negotiations. Even though RBI may process the proposals with some speed, even slight delays and breach of confidentiality can jeopardise deals. It is being suggested that at least A+ rated NBFCs may be allowed the automatic route.

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